

Disclaimer: This article appeared in the AIMA Journal (Autumn 2008), which is published by The Alternative Investment Management Association Limited (AIMA). No quotation or reproduction is permitted without the express written permission of The Alternative Investment Management Association Limited (AIMA) and the author. The content of this article does not necessarily reflect the opinions of the AIMA Membership and AIMA does not accept responsibility for any statements herein.

US Real Estate Continuing to Provide Appealing, Opportunistic Investments

By Bryan E. Gordon, Madison Capital Management, LLC

AIMA Journal Autumn 2008

Economic pundits and members of the financial press have painted a doomsday scenario for US real estate. Home prices are in decline. Housing starts are at multi-year lows and foreclosures have increased while credit has become harder to obtain. These tales of woe have led many domestic and international investors to become fearful of investing in US real estate.

Despite this, these problems have been largely isolated in residential real estate. Commercial real estate remains strong and continues to offer appealing investment opportunities. Investors who recognise that the US consists of many different real estate markets are poised to capitalise on continued market inefficiencies and acquire assets at attractive prices. These opportunities, while not easily identifiable, are ones with solid fundamentals that are able to be obtained at a discount to their implied or intrinsic value. Once identified, such assets can become profitable investments, with limited risk.

Real Estate: The Original Alternative Investment

With commercial real estate representing approximately 6.5 percent of US GDP growth over the 10 years to end of 2006, real estate has long been a significant portion of the US economy. The appeal of this asset class is understandable: Real estate can offer investors profitable investments whose returns exhibit low risk and low volatility, and are relatively uncorrelated with stocks and bonds, during both boom times and relatively lean years.

The attractiveness of real estate as an asset class can be confirmed by analysing more than 30 years of quarterly returns from the NCREIF Property Index and the indices shown in **Figure 1**. NCREIF exhibits a low to negative correlation to the equity and fixed income indices. In addition, when compared with the consumer price index (CPI), which measures the average price of goods and services purchased by households, returns on NCREIF and the 3 month Treasury Bill are the only two indices that exhibit a positive correlation to the CPI. That fact suggests real estate does provide investors with a hedge against inflation. This exists even when factoring in a two quarter lag on NCREIF returns to account for the relative illiquidity of real estate values as compared to more liquid instruments, such as equity and fixed income assets.

Figure 1

Correlations Between Different NCREIF and Broad Indices
First Quarter 1978 to First Quarter 2008

	NCREIF	S&P 500	ML 3 Month T-Bill	LEH Intermediate Term Treasury Index	LEH Credit Index	Consumer Price Index
NCREIF	1.00	(0.03)	0.23	(0.14)	(0.19)	0.29
S&P 500	(0.03)	1.00	(0.00)	0.07	0.25	(0.14)
ML 3 Month T-Bill	0.23	(0.00)	1.00	0.37	0.22	0.54
LEH Intermediate Term Treasury Index	(0.14)	0.07	0.37	1.00	0.93	(0.10)
LEH Credit Index	(0.19)	0.25	0.22	0.93	1.00	(0.25)
Consumer Price Index	0.29	(0.14)	0.54	(0.10)	(0.25)	1.00

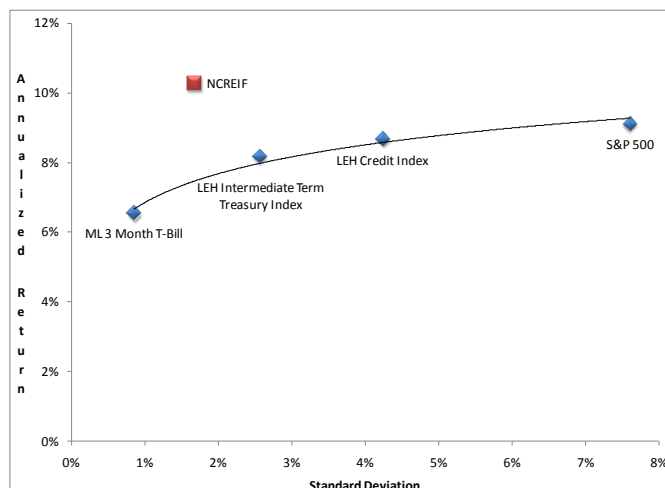
Correlations with NCREIF Lagged and UnLagged

	Unlagged	2 Quarter Lag	Variance
NCREIF	1.00	1.00	-
S&P 500	(0.03)	0.10	0.13
LEH Intermediate Term Treasury Index	(0.14)	(0.13)	0.01
LEH Credit Index	(0.19)	(0.12)	0.07
Consumer Price Index	0.29	0.28	(0.01)

Source: NCREIF, S&P 500, Lehman Brothers Cintermediate Term Treasury Index, Lehman Brothers Credit Index (high-grade), Consumer Price Index (all components, seasonally adjusted)

Apart from offering investors an alternative to equity and fixed income assets, real estate can provide relatively low volatility and superior risk adjusted returns compared to the indices listed (**Figure 1**). When comparing the annualised returns and volatility over the 30 years of returns identified, it is possible to observe a trade-off between volatility and return. Based on the data, NCREIF provides investors with a risk adjusted return superior to the other indices (**Figure 2**).

Figure 2



There is No Single US Real Estate Market

Although there is little dispute that real estate over time is an attractive asset class, the question that many investors have is whether real estate assets in the US will continue to appreciate. The primary flaw in this question is the misconception that there is a single US Real Estate Market.

The United States is a country with many different real estate markets, varying not only by region but also by property type. With a land mass of 9.8 million square kilometers and a population of approximately 305 million, the US is a country with many different localities. In fact, the US Office of Management and Budget has defined more than 950 Metropolitan Statistical Areas (MSAs) throughout the country. Each MSA has its own distinct social, economic and cultural characteristics. Consequently, while one MSA may post gains in average housing values, another may exhibit rapidly declining home prices. For instance, Denver, Colorado has exhibited steady population growth – approximately 14 percent between 2000 and 2007 – in part because the area is relatively affordable and offers a high standard of living and quality of life. Further, Denver is increasing its payrolls, with growth coming from energy, financial services and technology related businesses. As a result, demand for office space has outpaced supply, causing commercial vacancy rates to

decline. Unlike the trend in many parts of the US, the Mile High City's residential market might be showing signs of revival. Denver was one of eight markets nationwide to exhibit an increase in home prices between March and April, according to the S&P/Case-Shiller Home Price Index. The other markets were Boston, Charlotte, Chicago, Cleveland, Dallas, Portland and Seattle.

Within each of those markets, different asset types can and do perform differently. In a specific market the demand for office and housing may be rising because of increased population growth, while at the same time the appetite for high end shopping space would be declining because higher food and gas prices are eroding discretionary spending. That is why it is wise for investors to evaluate real estate deals one at a time and not draw broad conclusions, even within a single market.

Certain real estate markets are experiencing some distress, because each real estate asset's prospects and fundamentals are drivers specific to its location and property type. However, there continues to be appealing opportunities for investments in commercial real estate, which exhibit strong fundamentals.

Appealing Real Estate Investment Opportunities Still Exist

Although the commercial real estate sector has been plagued with increasing costs for debt, as a result of problems with the banking and capital markets, most commercial real estate markets remain healthy. Rents and occupancy rates remain at attractive levels. Commercial defaults have been stable and some markets are showing increased demand. Commercial mortgage backed security (CMBS) market spreads have widened dramatically compared to 2007 levels and issuances have fallen significantly. This slowdown is more a reflection of investor nervousness than a real indication of risk. According to Fitch's annual default study, US CMBS loan defaults remain low. Defaults in January 2008 were 0.27 percent of the loans outstanding, compared with 0.22 percent in 2007.

In general, investors should consider each investment opportunity based on the location and prospects for the property. Despite a slowdown in consumer spending, grocery stores and shops that sell basic consumer necessities continue to perform well, in part because demand for these goods tend to remain strong during good and

bad economic conditions. Further, although values of warehouse assets have declined, certain warehouses located in major distribution centres remain strong. Warehouses in areas that serve exporting companies are particularly attractive, partly because the declining dollar has increased international demand for US goods. Similarly, the declining dollar has increased tourism and demand in certain gateway cities (e.g., New York City), enabling hotel assets in those areas to hold up relatively well during the current economic slowdown. Some interesting investment opportunities include office buildings and multi-family apartment rental buildings in growing markets and healthcare related assets.

Fundamentals for office assets remain strong. Unlike previous commercial real estate recessions that were plagued by excess supply, the building of new commercial office space in recent years has been limited by high replacement costs and the drying up of credit liquidity. This has minimised the potential for a supply and demand imbalance. Many employers have learned a lesson from their experience during the 2001-2002 recession. Then many businesses reduced headcount and contracted office space. When the economy recovered and businesses were looking to expand again, they found they were re-leasing similar space at a premium to the rates they had previously paid. As a result, in this current downturn, many employers are retaining portions of their space to avoid costlier replacement when the market rebounds.

Multi-family rental apartment buildings in areas of steady population growth also appear promising, partly because rental rates have begun to increase from historic lows, driven by a decrease in home ownership and increased foreclosure rates.

As housing prices fall and mortgages become harder to obtain, a reversion to renting has been observed, stemming either from peoples' inability to obtain financing or from the fear of purchasing a potentially depreciating asset. Demand for rental apartments has also increased as a result of tenants being evicted from investment properties. Healthcare related real estate is another property type with long-term bullish prospects. Strong demand is being driven by population growth and longer expected life spans. Similarly, senior housing assets, ranging from senior communities and apartments to continuing care retirement communities, are likely to exhibit increased demand as baby boomers age.

Of equal importance to the fundamentals of a given real estate asset are the terms of the deal itself. Investors should focus on obtaining an asset at a discount to its intrinsic value. Instead of chasing the opportunity that has the attention of multiple investors, it is often better to search for opportunities located in pockets of inefficiency. These include:

- Investment opportunities that may require an exotic, creative transaction;
- financing at tiers of the capital stack, such as preferred equity, that some traditional financiers do not participate;
- opportunities with attractive assets in secondary and tertiary markets;
- situations with borrowers who struggle to obtain capital because they does not meet the “check the box” requirements demanded by some traditional financiers;
- a willingness by the borrower to post valuable assets as collateral for their loan;
- and opportunities that are considered too small by larger players

Further, investors should seize creative and indirect opportunities to invest in real estate. For instance, if a company with valuable real estate files for bankruptcy, it may be worthwhile to purchase the liabilities of the company, including bank debt or subordinated bonds, at a discount to that value.

In Closing

Real estate as an asset class has historically provided investors with attractive risk adjusted returns that are uncorrelated to other broad asset classes and offers a hedge against inflation. With that in mind, many institutional investors are viewing the downturn in the US and global stock markets as an opportunity to purchase real estate at a discount and have increased their real estate holdings. In a survey published by the “Real Estate Alert”, the US’s 50 largest public pension systems have pledged an additional \$36.2 billion to new real estate investments, an increase of 24 percent compared to 2006. Real estate as a percentage of total pension asset holdings increased from 4.9 percent to 6.3 percent.

Like the public pension fund systems, many seasoned financial professionals have created new investment funds and raised billions of dollars to capitalise on available opportunities in commercial real estate. They recognise that these assets, if purchased at a discount to the implied value of the asset, will continue to provide investors with profitable, low risk, investments that may diversify a traditional portfolio.